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INTERNATIONAL INVESTMENT AND COMPETITIVENESS

Working paper number 9
October, 1991

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Working paper number 9
October, 1991

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NOTE: Page 54 should begin as follows:

relatively high interest rates in Canada, which, in turn, have attracted heavy portfolio investment by foreigners. The appreciation . . .

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EXECUTIVE SUMMARY

The central theme of this report is that Canada's overall investment and savings effort will have to intensify considerably during the rest of the 1990s, as part of a broad based response to a relatively poor productivity performance during the 1980s. "Investing in Canada's future" is critical to how well we perform in the twenty-first century.

The working paper is in a question/response format, designed to contribute to public understanding and discussion about investment policy. Five sets of questions are addressed, which - together with the main observations pertaining to them - are summarized in point form below:

Past Investment Performance

- private-sector capital investment as a share of gross domestic product has grown steadily over the past two decades; the machinery and equipment component has improved dramatically; the latter is especially important, since it embodies technological advances; relative to some countries, notably Japan, Canada's machinery and equipment investment performance is still lagging;

- public sector investment has remained weak, reflecting fiscal restraint at all three levels of government;

- foreign direct investment (FDI) has augmented the investment effort; while an increasing share of FDI has been for acquisitions, most (80 %) of the doubling of the stock of FDI in Canada during the 1980s was as a result of reinvested earnings by foreign-controlled companies.

Future Investment Requirements

- future investment requirements depend in part on Canada's expected productivity performance; on the basis of educated assumptions about the growth of the labour force, the amount of capital used by the labour force, and capital/output ratios, it would appear that Canada's investment and savings effort will have to intensify considerably; this is so even if we aspire to only marginally improve upon the poor productivity gains of the 1980s;

- further, the quality as well as the quantity of investment obviously matters a great deal; there is some evidence that capital efficiency was a problem in the 1980s; because of corporate restructuring due to globalization, technology developments and other forces, it appears that machinery, equipment, and non-residential construction had shorter life cycles in the 1980s than originally provided for; continuation of this trend would necessitate greater investment;

- other factors, such as new environmental standards and infrastructure needs, also add to Canada's future investment requirements;

- more research and discussion is needed about the required investment effort, both its qualitative and quantitative dimensions.

The Need For Foreign Investment

- transnational corporations are leading the process of globalization; they constitute a crucial link between trade, capital and technology; whether foreign-owned or domestically-owned, their presence in Canada is essential for the competitiveness of the economy;

- foreign investment is increasingly two-way; Canadian direct investment abroad (CDIA) is also critical to competitiveness; at the end of 1990, the stock of CDIA was $85 billion, most of which was in the United States; the stock of FDI in Canada at the end of 1990 was $127 billion, most of which was accounted for by the United States;

- foreign direct investment, which entails at least some control of corporate assets, generates important benefits: technology transfers; international management expertise; production know-how and product innovation; the creation and preservation of high-value-added jobs; and access to international markets; these are long-term considerations;

- in contrast, foreign portfolio investment in Canada is importantly related to interest rate differentials and the current account position in the balance of payments; foreign portfolio investment, mainly in the form of bonds, has grown very rapidly in recent years in response to - until recently - relatively high interest rates in Canada and as an offset to the large current account deficit.

The Impact Of Foreign Direct Investment

- the impact of foreign direct investment on R&D and technology adoption in Canada appears to be generally positive; the transfers occur through such mechanisms as investment in machinery and equipment and the exchange of technical personnel; the benefits accrue both directly to targetted domestic firms and as "spillovers" to other domestic firms;

- the best way of guaranteeing that Canada realizes these benefits is by ensuring it has the skills and resources complementary to R&D; countries with considerable technological competence benefit most from foreign investment;

- foreign-controlled firms in Canada exhibit a high degree of R&D; further, Canadian-controlled firms subject to foreign takeover normally display an improved R&D intensity (i.e., R&D as a percentage of total revenues);

- more generally, foreign takeovers of Canadian firms normally result in productivity improvements; indeed, foreign firms are usually more productive than domestic-controlled firms of comparable size; further, foreign firms have a much higher propensity to export;

- while views about the impact of foreign investment vary widely, it is reassuring to note that experts such as Michael Porter (Harvard Business School), Richard Lipsey (Simon Fraser University), and Edward Safarian (University of Toronto) concur that an "open for business" policy is the correct choice.

The Investment Climate In Canada

- three sets of factors determine the investment climate: a country's overall economic performance; the attitude and policies of the government towards investment; and firm-specific requirements;

- investors in direct investments make their decisions based on long-term considerations; for them, what matters is the long-standing performance of a country concerning the three sets of factors mentioned above;

- from the confidence foreign investors have expressed in Canada for many decades now, it is clear that we are judged very favourably by international business interests; this judgement is reflected in the high ranking accorded Canada in the *World Competitiveness Report*;

- nonetheless, in this very competitive world there is no room for complacency; on the contrary, there have been a number of developments that could - if not responded to - cast a shadow over Canada's attractiveness as a place to invest; these developments include Canada's slow productivity growth and rising unit labour costs, plant closings and relocations due - according to some claims - to high taxes and other factors, and political uncertainty concerning Quebec;

- international competition for investment funds appears to be intensifying, underscoring the need for Canada to be very sensitive to its economic performance.

Canada's problems pale in comparison to many countries but it must continue to earn the respect of the international community through appropriate policies and actions - by both the private and public sectors. Investment policies and actions are especially relevant to Canada's future prosperity, and a consensus is needed on the domestic and international dimensions of the challenges involved.

INTRODUCTION

Canada is not in a crisis, but the country is confronted by great challenges. Globalization, or the growing integration of the world's major economies, has resulted in a fiercely competitive international environment. Canada will only maintain its position as one of the most advanced and wealthy of nations if its labour, capital, and natural resources continue to be utilized efficiently. Indeed, we must constantly strive to improve the way in which these resources are allocated, for our competitors have been rapidly catching up to North American productivity levels. Canada is still second only to the United States in terms of overall productivity, but countries such as Germany, Italy, and France have surpassed us in terms of productivity in the manufacturing sector. Ultimately, relative productivity levels are what determine relative and absolute standards of living. In turn, competitiveness is best described as a country's trade and productivity performance.

The Government of Canada has initiated an extensive series of consultations on the economy designed to ensure that all stakeholders in the country help to identify what needs to be done to protect and advance our future prosperity. Investment issues figure importantly in these consultations in recognition of the fact that "investing in Canada's future" is critical to how well we perform in the twenty-first century.

International investment has become a strategic instrument for trade development, technology transfer, management expertise, and the optimal use of scarce, highly trained personnel. Global industries (such as the automotive industry) demand global firms; this, in turn, means that the distinction between domestic and foreign firms is fading. International investment has also become increasingly two-way. Joint ventures and other forms of strategic alliances with foreign partners are especially relevant for a country like Canada, which must compete with much larger economies. Corporate restructuring in Canada is a reflection of worldwide developments.

In light of these considerations, domestic and international investment must be closely monitored. What follows, then, is a set of questions and some background information, to help focus discussion on one of the key pillars to Canada's future prosperity - the investment pillar.

Past Investment Performance

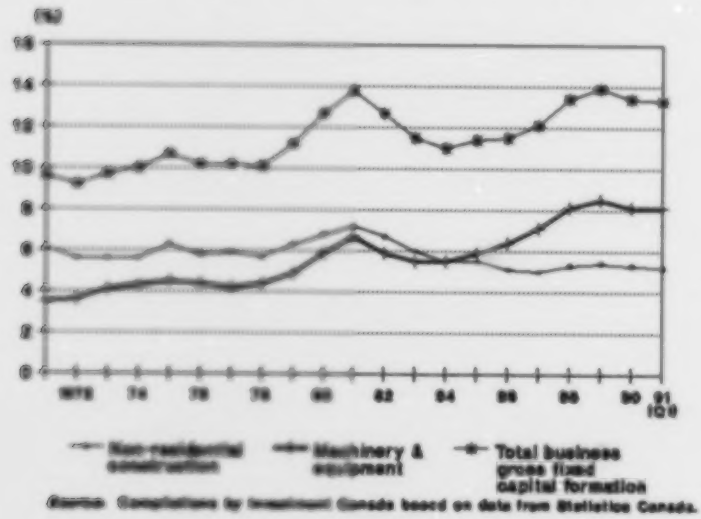
1. What was Canada's investment performance during the 1980s and very early 1990s? In particular, how strong (or weak) has business fixed capital formation been?

The performance has been volatile; but, in general, private-sector investment has been impressive.

- During the past decade, Canada experienced two recessions separated by a fairly long period of rapid growth -- especially during 1986-88.

- Private-sector capital investment, excluding housing, grew from 9.5 per cent of gross domestic product (GDP) in 1970 to 13.6 per cent in 1989 (Chart 1); the percentage dipped to 13.2 per cent in 1990, reflecting the effects of the 1990-91 recession.

CHART 1
BUSINESS INVESTMENT BY COMPONENT,
AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT
Canada, 1971 to 1st Quarter 1991



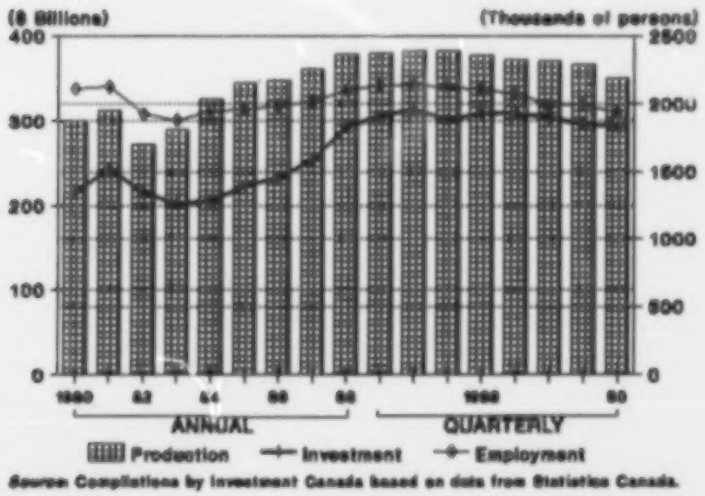
Source: Compilations by Investment Canada based on data from Statistics Canada.

- The machinery and equipment component of business investment strengthened during the 1980s (Chart 1). Whereas machinery and equipment outlays accounted for only 37 per cent of total business investment in 1970 (non-residential construction having accounted for the balance) and for 46 per cent in 1980, by the late 1980s and early 1990s the percentage was above or close to 60 per cent.

More dramatically, investment in machinery and equipment as a proportion of GDP was only 3.5 per cent in 1970, compared with 5.8 per cent in 1980 and 7.8 per cent in 1990.

- The rise in interest rates and the appreciation of the Canadian dollar in the latter half of the 1980s proved especially troublesome for some sectors; for example, manufacturing production fell in real terms by 10 per cent between August 1989 and December 1990, and manufacturing employment fell by an even greater amount (Chart 2).

CHART 2
MANUFACTURING PRODUCTION, INVESTMENT, AND EMPLOYMENT, Canada, 1980-90 (in 1986 dollars)

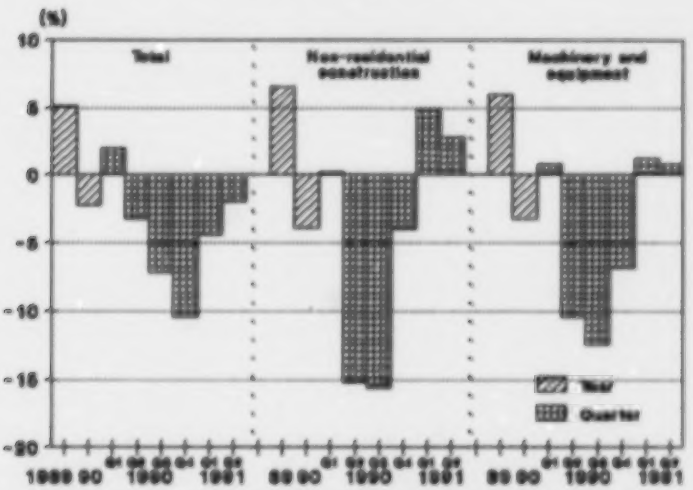


Source: Compilations by Investment Canada based on data from Statistics Canada.

- The 1990-91 recession resulted in a significant contraction in investment, especially in machinery and equipment outlays (Chart 3).

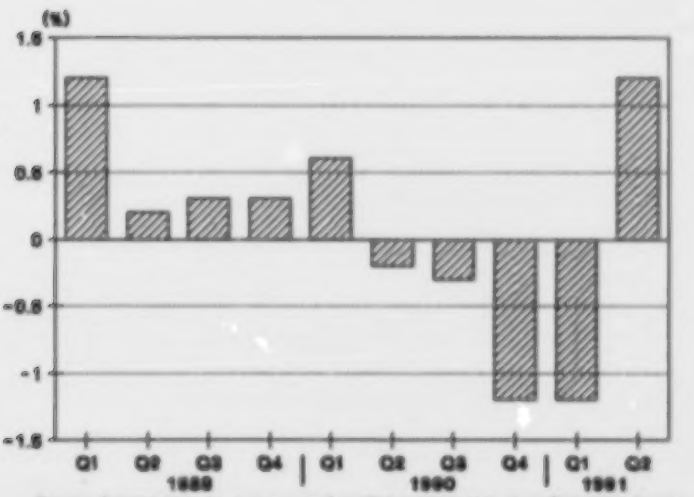
- The strong rebound in the GDP growth rate in the second quarter of 1991 (Chart 4) indicates that recovery from the recession is under way.

CHART 3
ANNUAL PERCENTAGE CHANGE IN REAL BUSINESS FIXED INVESTMENT,
Canada, 1989 to 2nd Quarter 1991



Source: Investment Canada compilations based on data from Statistics Canada.

CHART 4
QUARTERLY GROWTH IN REAL GROSS DOMESTIC PRODUCT,
Canada, 1989 to 2nd Quarter 1991 (in 1986 dollars)

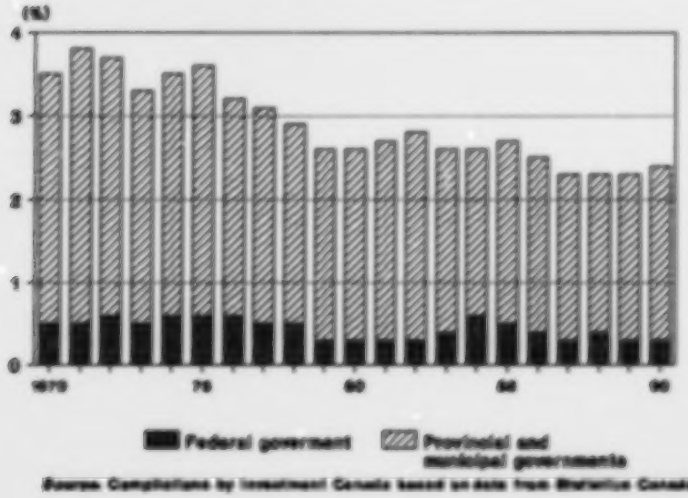


Source: Compilations by Investment Canada based on data from Statistics Canada.

Public-sector investment has been weak for a protracted period of time.

- Fiscal restraint (federal, provincial, and municipal) has meant that public-sector investment as a proportion of gross domestic product has continued to be relatively weak; government gross fixed capital formation (GFCF) as a proportion of GDP was 2.5 and 2.7 per cent in 1989 and 1990, respectively, compared with 3.6 per cent in 1970 (Chart 5).

CHART 5
GOVERNMENT GROSS FIXED CAPITAL FORMATION,
AS A PROPORTION OF GROSS DOMESTIC PRODUCT
Canada, 1970-90



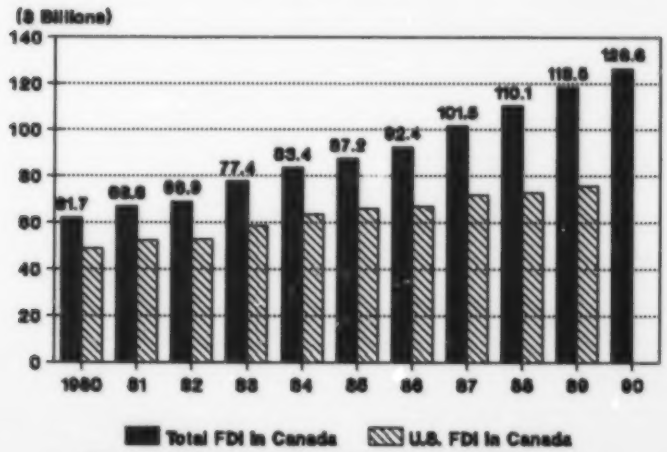
Source: Compilations by Investment Canada based on data from Statistics Canada.

2. What role has foreign investment played in augmenting the investment effort in Canada?

Foreign direct investment (FDI) in Canada has doubled.

- During the 1980s, the stock of foreign direct investment in Canada (which entails a significant degree of foreign management control of corporate assets) increased from $61.7 billion to $126.6 billion by the end of 1990 (Chart 6).

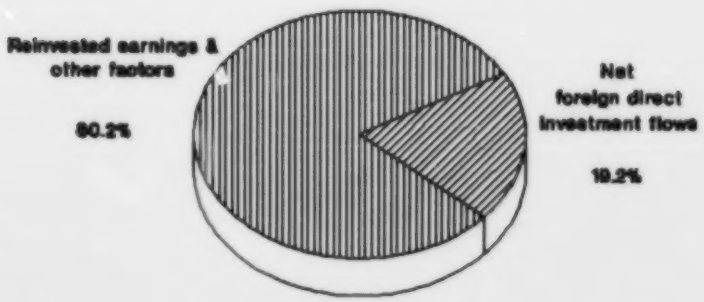
CHART 6
TOTAL AND U.S. FOREIGN DIRECT INVESTMENT IN CANADA,
1980-90*



*Note: The 1990 breakdown by country is not yet available.
Source: Compilations by Investment Canada based on data from Statistics Canada.

- Most of the increase (80 per cent) was due to reinvested earnings by foreign-controlled enterprises in Canada, reflecting a high degree of confidence in the Canadian economy (Chart 7).[1]

CHART 7
THE RELATIVE IMPORTANCE OF REINVESTED EARNINGS VERSUS CROSS-BORDER FLOWS TO THE GROWTH OF FDI IN CANADA,
1980-90

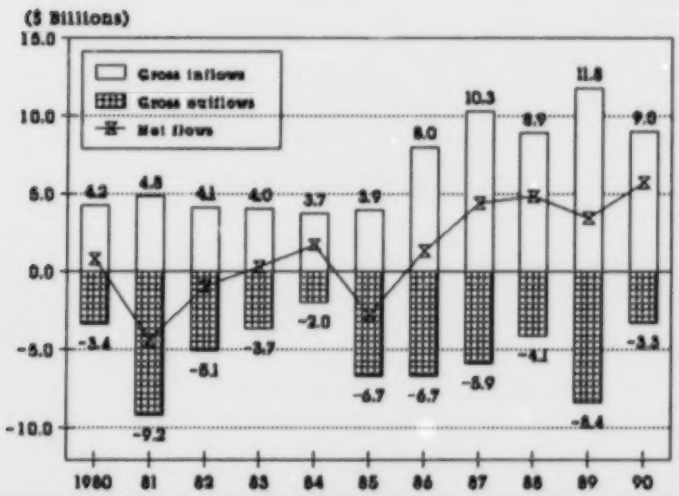


Source: Compilations by Investment Canada based on data from Statistics Canada.

[1] Had the earnings not been reinvested, they would have been reflected in the balance of payments as an outflow — either in the current or capital account, depending on how the earnings were transferred.

- Cross-border flows of foreign direct investment have more than doubled since the federal government declared Canada "open for business" in 1984. Whereas gross cross-border inflows of FDI averaged $4.2 billion annually during the first half of the 1980s, they averaged $8.6 billion annually during the latter half (Chart 8). An increasing share of these inflows was for acquisition purposes, including foreign acquisitions of already foreign-controlled Canadian firms. This latter occurrence, together with other forms of divestiture, has meant that gross cross-border outflows of FDI have also increased considerably.

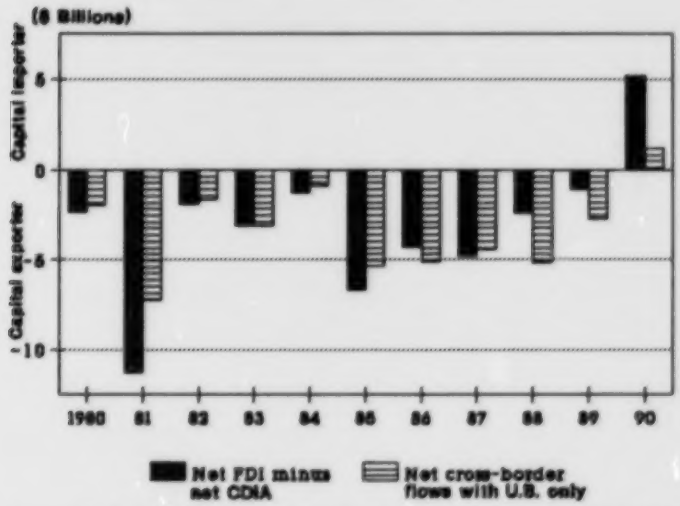
CHART 8
NET FOREIGN DIRECT INVESTMENT FLOWS,
Canada, 1980-90



Source: Compilations by Investment Canada based on data from Statistics Canada.

- In addition to cross-border flows of FDI are the cross-border flows of Canadian direct investment abroad (CDIA). The net of these two sets of cross-border flows (i.e., foreign direct investment in Canada and Canadian direct investment abroad) was $5.1 billion in 1990 — the first net inflow since 1974 (Chart 9). This development was "broadly consistent with the view that the free trade agreement between Canada and the United States has enhanced Canada's attractiveness as a destination for foreign investment" (*Bank of Canada Review*, April 1991). European and Japanese investment in Canada has strengthened appreciably.

CHART 9
NET FDI CROSS-BORDER FLOWS LESS NET CDIA CROSS-BORDER FLOWS,
Canada and the United States, 1980-90



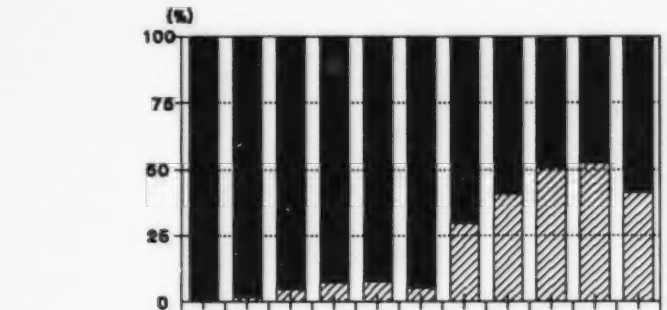
Source: Compilations by Investment Canada based on data from Statistics Canada.

- As already mentioned, a significant proportion of FDI inflows was for acquisitions rather than for new businesses or expansions of existing businesses (Chart 10). Worldwide merger and acquisition activity peaked in 1989. Since that time there has been a pronounced moderation in such activity, in line with the economic slowdown and greater care in credit allocation. Very recently, there has been some revival in merger and acquisition activity in Canada and the United Kingdom.

Foreign portfolio investment in Canada has more than doubled.

- The stock of foreign portfolio investment in Canada (which entails no, or minimal, foreign management control) was $229 billion in 1990, compared with $69.7 billion in 1980 (Chart 11).

CHART 10
"GREENFIELDS"/EXPANSIONS AND ACQUISITIONS IN GROSS FDI INFLOWS,
1980-90

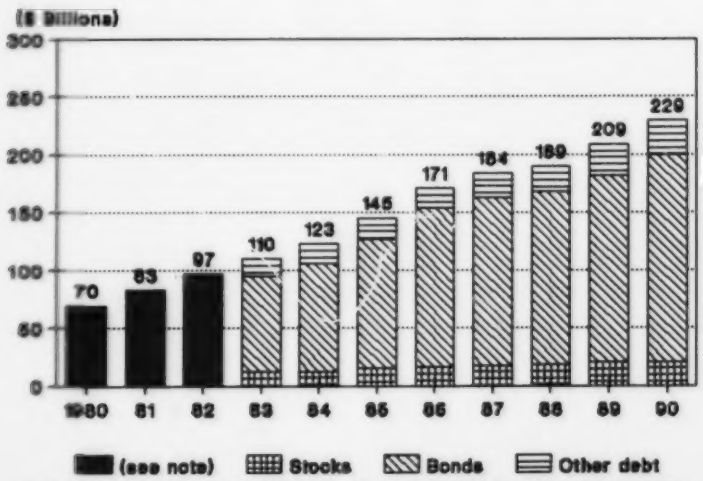


($ Billions)	1980	81	82	83	84	85	86	87	88	89	90
New business and expansion	4.2	4.7	3.9	3.7	3.5	3.7	5.7	6.1	4.4	5.6	5.3
Acquisitions	0.0*	0.1	0.2	0.3	0.3	0.2	2.4	4.2	4.5	6.2	3.7
Gross FDI inflows	4.2	4.8	4.1	4.0	3.8	3.9	8.1	10.3	8.9	11.8	9.0

Acquisitions New business and expansion

Note: 1980 acquisitions amounted to less than $100 million.
Source: Compilations by Investment Canada based on data from Statistics Canada.

CHART 11
STOCK OF FOREIGN PORTFOLIO INVESTMENT IN CANADA,
1980-90



Note: The composition of portfolio investment from 1980 to 1982 is not available.
Source: Compilations by Investment Canada based on data from Statistics Canada.

- Most of this investment is in bonds, particularly government bonds. These portfolio holdings are a reflection of the public-sector deficit and the current account deficit. The collective gross public debt of all levels of government in Canada is now equal to 73 per cent of the GDP, compared with 55 per cent in the United States, 61 per cent in Japan, 47 per cent for both France and Germany, 34 per cent in the United Kingdom, and 101 per cent in Italy (OECD, *Economic Outlook*, December 1990). The current account deficit in 1990 was $22 billion, or 2.4 per cent of gross domestic product. In fact, the striking increase in foreign portfolio investment in Canada since the first half of the 1980s reflects in large measure the swing from a sizeable current account surplus to a very large deficit.

- Net foreign indebtedness was $259 billion at the end of 1990, or 38 per cent of GDP. Canadians must guard against unduly relying upon foreign capital to finance consumption rather than productive investment. Domestic savings and investment must be better balanced than they are now, which underscores the importance of reducing the deficit position of the public sector.

Future Investment Requirements

1. What are the investment requirements for the remainder of this decade? Must Canada intensify its investment effort in order to improve its trade and productivity performance?

Many factors indicate that Canada's investment effort must intensify, although by how much is an open question.

- This country's competitive position has slipped, relative to a number of European countries, Japan, and the "seven tigers" of the Asian-Pacific Region.[2]

- According to estimates by the Economic Council of Canada, some countries are rapidly catching up to Canada in terms of manufacturing productivity. Indeed, during the 1980s, Germany, Italy, and France surpassed Canada's level of manufacturing productivity; furthermore, after converging with United States levels throughout most of the postwar period, the gap between Canada and the U.S. has begun to widen since 1985 (Table 1). Greater investment effort is just one of many responses needed to strengthen Canada's productivity performance.

TABLE 1
LEVEL* OF MANUFACTURING PRODUCTIVITY IN CANADA RELATIVE TO THAT IN THE OTHER G-7 COUNTRIES, 1955-89**
(Canada=100)

	U.S.A.	Japan	France	Germany	Italy	U.K.
1955	160.6	19.7	60.1	63.1	55.5	65.5
1960	143.7	24.3	65.8	77.2	58.6	62.3
1965	138.0	28.6	69.4	80.7	66.7	57.6
1970	125.2	45.6	84.3	91.5	80.0	60.1
1975	122.8	52.6	89.4	98.8	86.3	60.5
1980	120.9	66.4	100.6	107.4	100.0	58.6
1985	123.4	73.0	99.7	106.3	108.6	64.9
1988	128.3	81.2	103.7	106.2	108.1	70.3
1989	134.0	85.4	111.0	109.5	115.2	76.7

* Output per hour.
** Based on purchasing-power parity rates, disaggregated by major industry.

Source: Estimates by the Economic Council of Canada, based on unpublished data from the U.S. Department of Labor, April 1990.

[2] Namely, Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand.

- Investment effort is usually defined as the ratio of gross fixed capital formation to gross domestic product; on that basis, comparisons with other OECD countries would appear to be reassuring, for Canada's investment effort has compared favourably over most of the postwar period. Canada has some unique features, however, that demand a higher investment effort than is required in other countries.

- Most notably, the labour force in Canada has experienced a much more rapid growth than that in many other countries. Comparisons of investment effort are more appropriate, therefore, if based on changes in capital/labour (C/L) ratios; by that measure, Canada managed to keep pace with most other G-7 countries during the 1980s, in spite of significantly weaker growth in its C/L ratio during the 1960s and 1970s (Table 2).

TABLE 2
AVERAGE GROWTH IN REAL PRIVATE NON-RESIDENTIAL GROSS FIXED CAPITAL STOCK, TOTAL CIVILIANS EMPLOYED, AND CAPITAL STOCK PER CIVILIAN EMPLOYED, SELECTED COUNTRIES AND PERIODS 1965-87

	Real private non-residential gross fixed capital stock			Total civilians employed		
	Average annual growth rate					
	1965-73	1973-80	1980-87	1965-73	1973-80	1980-87
Canada	5.15	5.19	3.83	2.94	2.91	1.47
France	5.64	4.3	2.53	0.82	0.32	-0.21
Germany	5.27	3.47	2.76	0.00	-0.34	0.45
Japan	13.00	6.86	7.73	1.33	0.74	0.94
U.K.	3.82	2.80	1.91	-0.03	0.17	-0.14
U.S.	4.11	3.72	3.16	2.27	2.24	1.79
Average	6.17	4.39	3.65	1.22	1.01	0.72

	Average annual growth rate in capital/labour ratio*		
	1965-73	1973-80	1980-87
Canada	2.15	2.22	2.33
France	4.78	3.97	2.75
Germany	5.28	3.82	2.29
Japan	11.51	6.08	6.73
U.K.	3.86	2.63	2.06
U.S.	1.80	1.45	1.34
Average	4.89	3.36	2.92

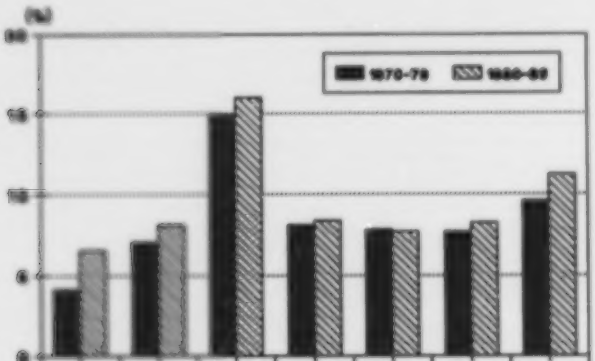
* Real private non-residential gross fixed capital stock divided by the number of employed civilians.

Source: Compilations by Investment Canada based on data from OECD, Flows and Stocks of Fixed Capital, 1962-87 and from OECD, Labour Force Statistics, 1968-88.

- Other measures of investment effort (including those at the sectoral level) are needed to compare international performance properly. Canada has a relatively heavy reliance on resource-based industries, which are capital-intensive; for that reason alone, it could be expected that Canada's investment effort would have to be relatively more intensive.

- The strength of investment in machinery and equipment in Canada during the past decade pales in comparison with that of some of its major competitors. Investment in machinery and equipment as a percentage of the gross domestic product has been less than half the Japanese level for the past 20 years (Chart 12). Investment in machinery and equipment is believed to be especially productive, since it normally embodies technological advances.

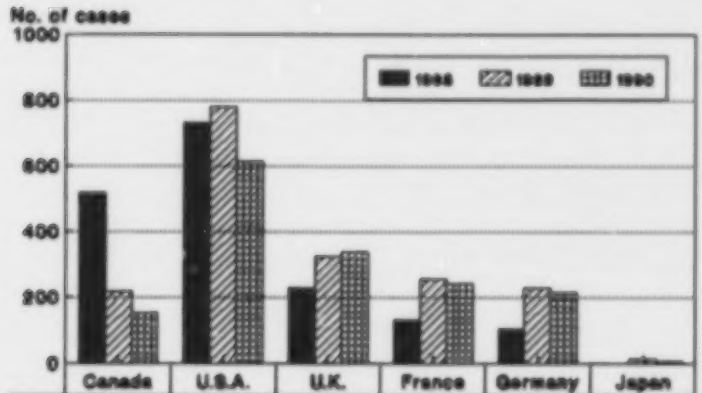
CHART 12
INVESTMENT IN MACHINERY AND EQUIPMENT, AS A PROPORTION OF GROSS DOMESTIC PRODUCT IN THE G-7 COUNTRIES, 1970-89



Source: Compilations by Investment Canada based on data from OECD, Economic Outlook.

- Globalization, the Free Trade Agreement, technological changes, and other factors are accelerating the pace of industrial restructuring and rationalization in Canada, thereby requiring greater investment effort. One indicator of such acceleration has been the wave of merger and acquisition activity in recent years (Chart 13). According to research conducted on behalf of Investment Canada, the degree of merger and acquisition activity has been higher in Canada than in most other industrialized countries; see L. Waverman, General Editor, *Corporate Globalization Through Mergers and Acquisitions* (Ottawa: Investment Canada, forthcoming).

CHART 13
TRANSBORDER MERGER AND ACQUISITION ACTIVITY,
Selected G-7 Countries, 1988-89



	Canada	U.S.A.	U.K.	France	Germany	Japan
1988	617	729	228	129	101	
1989	215	778	323	256	226	14
1990	152	613	337	239	213	6

Note: 1988 transactions for Japan are not available.
Source: Compilations by Investment Canada based on data from KPMG Dealwatch.

- Canada's labour force is growing at a much slower rate than it did in the 1960s, 1970s and early 1980s; hence, firms finding a shortage of labour, especially skilled labour, may substitute increasing amounts of capital. In short, the capital/labour ratio may increase more rapidly than it has up until now. For this to occur the relative prices (or returns) of capital and labour must shift in favour of the former. Otherwise Canada's overall potential output will grow at a slower rate.

- Recent revisions by Statistics Canada to capital stock data incorporate new, much shorter life cycles during the 1980s for machinery, equipment and non-residential construction. These adjustments, together with alterations to the deflators used to estimate the real value of investment, suggest that the growth in total factor productivity during the 1980s was somewhat better than the OECD has reported for Canada. Also, analysis of the revised capital stock data indicates that there were some significant capital efficiency problems over the past decade.

- New environmental standards and a growing interest on the part of Canadians in the concept of sustainable development will require additional investment effort. Informetrica, an Ottawa-based consulting firm, has estimated that additional capital expenditures of $70 billion (in constant 1989 dollars) will be needed over the decade of the 1990s to meet a specified range of environmental standards; this translates into a 2-percentage-point increase in investment effort. Alternatively, there could be offsetting declines in investment in other areas but this would

appear ill-advised as this could be at the expense of much needed productivity gains.

- The future retirement needs associated with the aging of the population indicate yet another reason why the savings and investment effort must be intensified. Estimates prepared by C. Schultze, the former chairman of the Council of Economic Advisors, suggest that an additional 2.5 per cent of national income will be required to meet future retirement needs in the United States. A similar increment in savings and investment may be required in Canada, although this observation should be tempered by demographic differences between the two countries and the fact that the changing age structure is more relevant to longer-run considerations.

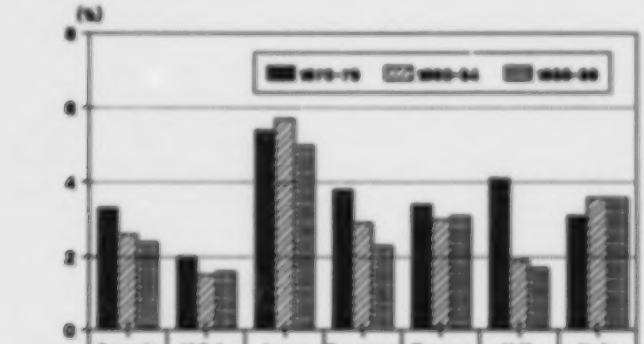
- The maintenance of first-class transportation systems, water -and sewage systems, communications, and other forms of public infrastructure greatly affects productivity performance. According to some experts, however, many elements of Canada's public infrastructure are outdated or decaying. The Federation of Canadian Municipalities has concluded that a major remedial program is required. Infrastructure outlays in Canada tend to be higher than in other countries because of its more rapid population growth (60 per cent faster than the average for all the G-7 countries over the past decade), its vast geography and low population density, and its harsh climate (which increases the cost of building and maintaining its infrastructure). Government gross fixed capital formation as a proportion of the GDP was 2.7 per cent in 1990, which was a full percentage point above the level in the United States. Part of this difference reflects the greater reliance on contracting out to the private sector in the United States; part is an indication of serious U.S. neglect; but part reflects Canada's severe climate, vast geography, and low population density. In any case, a comparison with the United States may not be the appropriate comparison; during the 1980s, governments in Japan, Italy, France, and Germany all committed more to investment in infrastructure than did Canada (Chart 14).

- It is estimated that the overall investment effort (i.e., gross fixed capital formation as a proportion of GDP) should be increased from approximately 22 per cent currently to a range of 28 to 30 per cent; this estimate was derived from analysis conducted under contract to Investment Canada by Dr. David Slater, the former Chairman of the Economic Council of Canada.[3] An increase of that magnitude in Canada's investment effort would contribute to some improvement in labour

[3] David Slater, The Contribution of Investment and Savings to Productivity and Economic Growth in Canada, Investment Canada, forthcoming.

productivity growth (which was only 1.5 per cent per annum over the past decade, compared with rates of 3 per cent or more during the 1960s and early 1970s). Furthermore, this intensification of the investment effort would allow for a more rapid improvement in the capital/labour ratio than occurred in the 1980s.

CHART 14
GOVERNMENT GROSS FIXED CAPITAL FORMATION
AS A PROPORTION OF GROSS DOMESTIC PRODUCT IN THE G-7 COUNTRIES,
1970-89



	Canada	U.S.A.	Japan	Germany	France	U.K.	Italy
1970-79	3.3	2	5.4	3.8	3.4	4.1	3.1
1980-84	2.8	1.5	5.7	2.9	3	1.9	3.6
1985-89	2.4	1.8 *	5	2.3	3.1	1.7	3.6

* 1989 data for U.S.A. were not available.
Source: Computations by Investment Canada based on data from OECD, Economic Outlook.

- If more ambitious productivity and capital/labour goals are adopted and if Canadians are determined to improve significantly the quality of the environment, the state of public infrastructure, and provisions for an aging society, then an investment effort in excess of 30 per cent may be needed.

- More research should be undertaken to determine Canada's investment requirements and whether these are attainable; this is particularly true at the sectoral level. Some economists will argue that, in the absence of serious market failures concerning the international allocation of capital, and the absence of domestic factors interfering between rates of return and the marginal productivity of capital, private investment should automatically adjust to the desired levels. This view is based upon a number of critical assumptions, including those concerning technological change. There is a lot at stake in this view and it is open to challenge. Further research and discussion, therefore, are necessary.

2. Will an increase in investment effort be sufficient or must the quality of the effort also improve?

There is considerable evidence to the effect that the quality of the investment effort must improve. Indeed, some might argue that this is all that is needed.

- Simply pumping up the investment effort is no guarantee that productivity growth will be high. Although there is a broad correlation among OECD countries between investment effort and productivity growth, there is no consistent relationship on an individual-country basis; Australia, for example, has had a strong investment effort but a weak productivity performance.

- Other factors, such as education and training, also greatly influence productivity. There must, therefore, be a comprehensive and coordinated policy approach in Canada involving both macro- and micro-economic factors (i.e., overall fiscal and monetary management of the economy and policies concerning the labour force and other resource-utilization factors).

- The productivity/investment relationship must be re-established. Particular attention must be paid to investments in innovation (or innovation processes), as this appears to have been the most serious area of weakness during the 1980s.

- Some experts (most notably Sylvia Ostry, in Canadian Competitiveness: Muddling Through) argue that the relationship between investment and productivity may have become "disconnected".

- The international competition for investment has intensified; this affects Canada's ability both to attract funds from abroad and to encourage domestic funds to be employed domestically. Regarding the international competition for funds, it must be stressed that the industrialized world will be facing similar pressures as Canada from both increased investment needs and possible "shortfalls" of savings. This risk has been compounded by the increased demand for savings to rebuild shattered East European economies (and possibly the Soviet Union) as well as for reconstruction in the Middle East. The net result of these pressures will not be an increase in capital inflows to all countries. Rather, it will be upward pressure on the real cost of funds, of whatever extent balances world demand and supply for savings. Regarding the latter, the market value of assets held in Canadian pension funds exceeded $190 billion in 1989. Clearly, the way in which life insurance and pension funds are placed and managed affects Canada's investment and productivity performance.

The Need for Foreign Investment

1. Is international investment critical to Canada's competitiveness?

Critical may be too strong a word, but it is indisputably very important.

- There are several types of benefits from foreign direct investment in Canada, including the following:

  i) technology transfers (e.g., the transfer of technology from 3-D Systems in California to Factotum Compusystems in Ontario);

  ii) international management expertise (e.g., Toyota's automobile plant in Cambridge, Ontario, received the J. D. Power and Associates Gold Plant Quality Award this year for being the manufacturing plant in North America that ranked the highest in product quality);

  iii) production know-how and product innovation (e.g., Kubota Corporation provided Fahramet Steel Castings, Orillia, Ontario, with advanced technology in the areas of smelting, centrifugal castings, machinery, and welding);

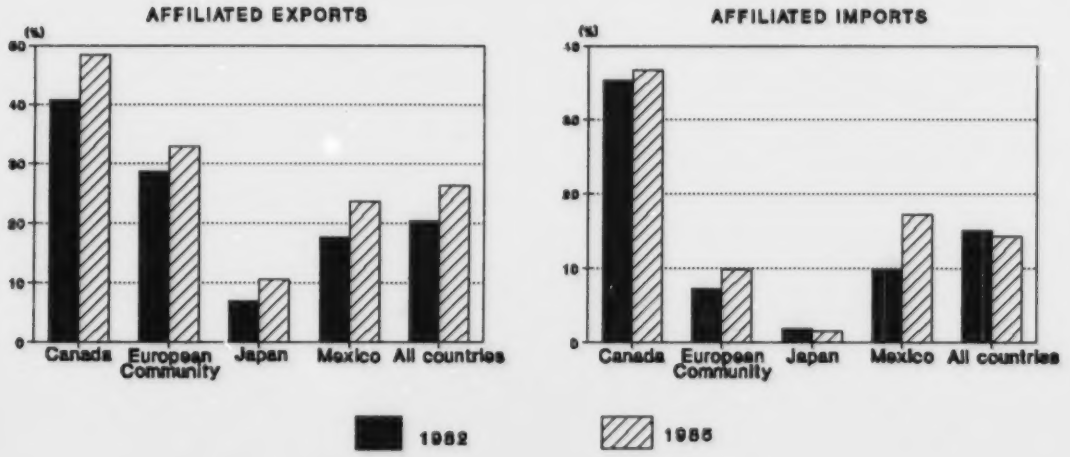
  iv) the creation and preservation of high-value-added jobs (e.g., Sammi Steel Company is investing $350 million in the Atlas Steel operations in Tracy, Quebec, increasing the production of stainless steel fourfold and creating 350 new jobs);

  v) the acquisition of access to new markets and international markets (e.g., Motorola agreed to provide access to its vast international marketing network to Mobile Data International of British Columbia); and

  vi) other benefits, such as taxes and retained earnings. Between 1984 and 1990, almost two-thirds of the growth of FDI in Canada resulted from reinvested earnings, demonstrating the confidence that foreigners have in the economy.

- Multinational enterprises (MNEs) are leading the process of globalization. They constitute a crucial link between trade, capital, and technology flows. They account for the vast majority of Canada's total imports and exports, and their importance in world trade has been increasing (Chart 15).

CHART 15
U.S. INTRAFIRM MERCHANDISE TRADE WITH FOREIGN AFFILIATES,
Selected Countries/Regions, 1982 and 1985

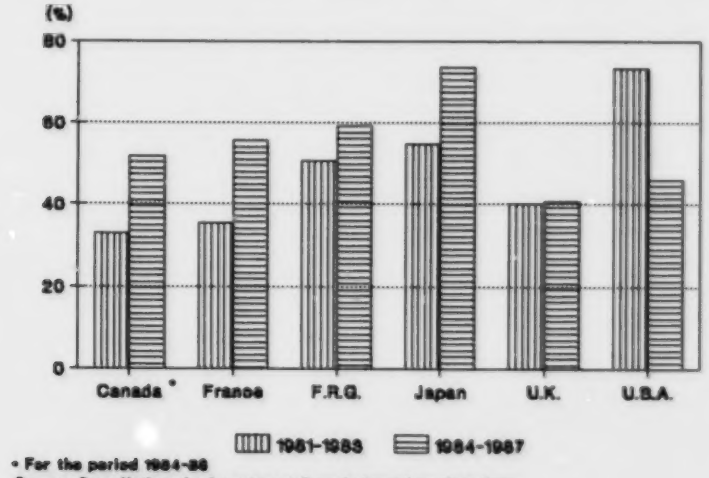


Note: Intrafirm trade calculated as a proportion of total U.S. merchandise trade.
Source: Compilations by Investment Canada based on data from the U.S. Department of Commerce.

- The economic integration that occurs through FDI is quite different from the integrating effects of trade; for example, some 50 per cent of cross-border flows of direct investment are related to the service sector (Chart 16). Foreign direct investment is intensifying international competition in the "non-traded" sector, as is the case of manufacturing.

- According to Dr. Michael Porter, Canada must seek to have MNE operations located here, whether they be as subsidiaries of foreign parents, as headquarters for foreign-owned operations, or as Canadian-owned and -controlled firms with some operations in Canada but perhaps with the bulk of their operations overseas (e.g., Northern Telecom, Bombardier, or McCain Foods). In 1991, of the Financial Post's top 500 companies in Canada, 175 were at least 50 per cent foreign-owned.

CHART 16
AVERAGE ANNUAL SERVICES AS A PROPORTION OF FDI OUTFLOWS FROM DEVELOPED ECONOMIES,
Selected Periods, 1981 to 1987

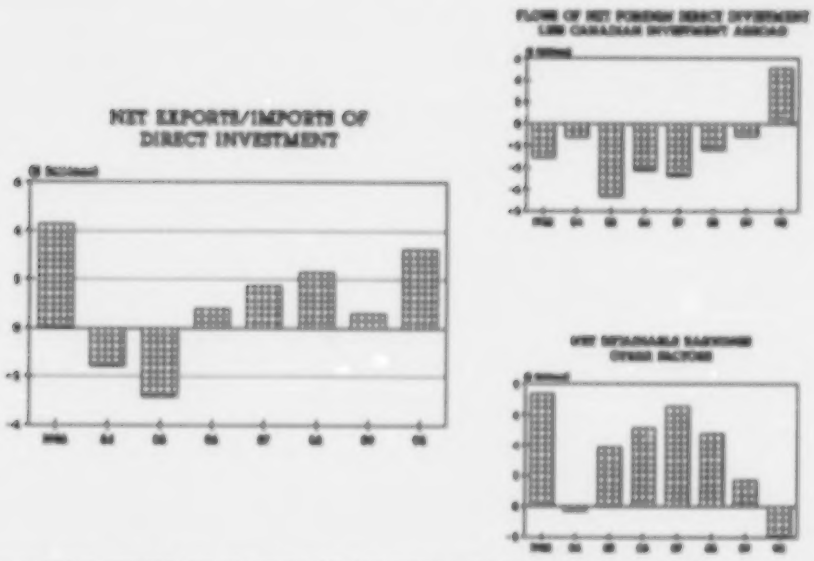


* For the period 1984-88
Source: Compilations by Investment Canada based on data from the United Nations Centre on Transnational Corporations.

- There has been a shortfall in domestic savings relative to overall investment requirements. Canada was a modest net capital importer during much of the postwar period; however, it became a heavy net capital importer during the 1980s, largely because government dissaving grew significantly. While most of the gap between domestic savings and investment was offset by inflows of foreign portfolio investment, Canada also became a significant net importer of direct investment funds. In 1990, direct capital imports amounted to approximately $3.5 billion (Chart 17). In light of the need for increased investment effort by Canada and given the fiscal outlook for the combined government sector, even greater imports of direct investment would appear to be necessary throughout the rest of this decade.

- This latter point is reinforced by the fact that Canadian direct investment abroad has become very important, as described in the next question.

CHART 17



Source: Investment Canada compilations using data from Statistics Canada.

2. Is the need for foreign investment two-way? Is Canadian direct investment abroad also critical to Canada's competitiveness?

The answer is "Yes" to both questions.

- International investment is becoming increasingly related to trade competitiveness; it has become the key strategic means for firms to become transnational organizations and to rationalize their activities on a global basis.

- Firms invest abroad in order to gain from economies of scale and scope. From surveys conducted by Investment Canada (which are consistent with many academic studies), the five most significant factors influencing Canadian direct investment abroad are:

  i) the perceived need for outward expansion;
  ii) geographical/product-line diversification;
  iii) trade barriers and transportation costs;
  iv) the availability of skilled labour; and
  v) favourable regulations abroad.

- The first two factors that influence CDIA are internal to Canadian firms in that they reflect specific corporate values; the other three "pull factors" reflect perceived advantages in the host country.

- At the end of 1990, the stock of CDIA was $85 billion. Some 1,500 firms in Canada have investments abroad, and most of these (75 per cent) are Canadian-controlled. A relatively small number of firms in the accompanying list (Table 3) account for 80 per cent of CDIA, and most of CDIA (65 per cent) is in the form of majority owned or wholly owned affiliates. Joint ventures, however, have been increasing in importance. More than 70 per cent of all CDIA is in the United States.

- According to a 1989 survey of high-technology firms by Ernst and Young, half of the respondents were involved in international joint ventures; some factors of production, such as research and development, have become too costly for single firms.

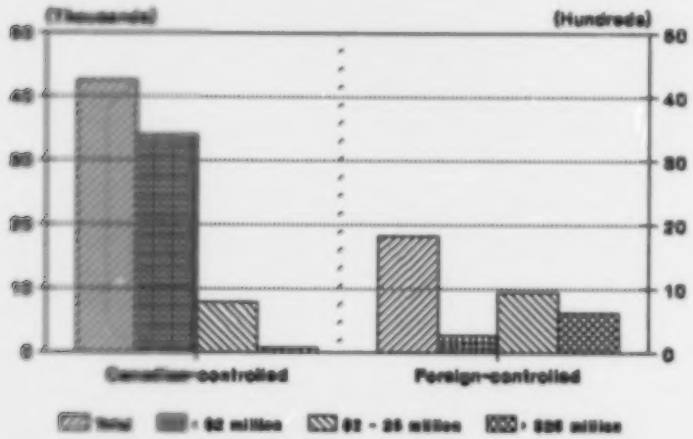
TABLE 3
CANADIAN FIRMS ACTIVE IN FOREIGN ACQUISITIONS, 1979-90

Firm	# of acqs.	Firm	# of acqs.
Alcan Aluminum Ltd.	7	Jannock Ltd.	13
Arc International	4	John Labbatt Ltd.	6
Bank of Montreal	4	Laidlaw Transportation	7
Bombardier Inc.	6	Lawson Mardon	4
Campeau Corp.	4	MacLean-Hunter Ltd.	12
Canadian Pacific	10	McCain Foods Ltd.	5
CCL Industries	6	Memotec Data Inc.	5
Cineplex Odeon	6	Mutual Life Assurance Co.	5
Crownx Inc.	4	National Business Systems Inc.	6
Derlan Industries	6	Noranda Inc.	5
Dominion Textiles	5	Olympia & York Development Ltd.	6
Domtar Inc.	7	Royal Trustco Ltd.	7
First City Financial Corp.	20	Seagram Company Ltd.	7
First Toronto Capital Corp.	6	SHL Systemhouse Inc.	4
Genstar Ltd.	7	Thompson Newspapers Ltd.	17
George Weston Ltd.	4	Trimac Ltd.	4
Hollinger Inc.	12	Triuc Ltd.	4
Imasco Ltd.	6	Unicorp Canada Corp.	14
International Thompson Organization	38	Unicorp Financial Corp.	9
Ivaco Inc.	7		

Source: Compilations by Investment Canada based on data from ADP Data Services.

- The small scale of most Canadian firms underscores the importance of strategic alliances with overseas partners. Whereas the vast majority of Canadian-controlled manufacturing companies have annual sales of less than $2 million, only a small proportion of foreign manufacturing companies operating in Canada are of that scale; 30 per cent of foreign manufacturing companies have sales in excess of $25 million, compared with less than 2 per cent of Canadian companies (Chart 18).

CHART 18
NUMBER OF ACTIVE MANUFACTURING COMPANIES,
by sales size group, 1987



Source: Compilations by Investment Canada based on data from Statistics Canada.

- The proposed North American Free Trade Agreement (NAFTA) illustrates the importance of CDIA. In contrast to the Free Trade Agreement with the United States, the extension of free trade to include Mexico is not founded on a strong network of well-established business relationships between Canada and Mexico. Mexico accounts for less than 1.0 per cent of Canada's exports, and Canada accounts for only 1.5 per cent of foreign direct investment in Mexico.[4] In order to benefit from the rapidly expanding export opportunities in the Mexican market, Canadian firms in many cases will have to establish a presence in Mexico.

[4] Investment Canada, The Opportunities and Challenges of North American Free Trade: A Canadian Perspective, Working Paper No. 7 (Ottawa: 1991).

The Impact of Foreign Direct Investment

1. What is the evidence with respect to the impact of foreign direct investment on R&D and technology adoption in Canada?

While there is a great diversity of views concerning this question, the impact of foreign investment appears to be generally positive.

- The two main benefits of FDI are technology transfers to the target domestic firm and the spillovers from those transfers to other domestic firms. The transfers occur through such mechanisms as investment in machinery and equipment, education and training, and the exchange of technical personnel;[5] "forward and backward" linkages between the transnational corporation and its domestic suppliers and customers lead to a wide diffusion of the benefits derived from technology transfers.

- It is prohibitively expensive for Canada to develop leading-edge technologies across a wide range of economic activities; it is important, therefore, for Canada to promote foreign investment and thereby the rapid adoption of technological innovations.

- Increasingly, the organizational structure of large firms is becoming transglobal; that is, all components of production and distribution are rationalized on a global basis. R&D is increasingly undertaken where factor endowments and costs are most favourable; in this context, ownership matters less than performance.

- Transnational corporations tend to locate research facilities in countries with complementary skills and resources. Countries with considerable technological competence benefit most from foreign investment.[6]

- Tax data indicate that the R&D intensity of foreign-owned Canadian manufacturing firms is far above average and that the R&D intensity actually increases following acquisition.[7]

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[5] See D. McFetridge, ed., Foreign Investment, Technology, and Economic Growth, Investment Canada (Ottawa: 1991). This publication includes a series of papers by internationally recognized experts as R. Lipsey, R. Harris, J. Cantwell, M. Blomstrom, J. Bernstein, S. Globerman, and D. Teece, among others.

[6] See "The Technological Competence Theory of International Production and Its Implications," by John Cantwell, in Investment Canada, Foreign Investment, Technology, and Economic Growth.

[7] D. Allen, Performance of Canadian- and Foreign-Controlled Manufacturers in Canada, 1983-87, a study prepared for Investment Canada, 1990.

- According to Statistics Canada:
  - The R&D expenditures of 450 foreign-controlled firms in Canada were reported to be $1.6 billion in 1988, which amounted to 36 per cent of the total.
  - The percentage of industrial R&D accounted for by Canadian-controlled firms varied considerably among the different sectors of the economy; in the case of the engineering and scientific services sector, Canadian-controlled firms accounted for 82 per cent of industrial R&D, while in the case of the aircraft and parts sector they accounted for only 17 per cent (Table 4).
- Foreign-controlled high-tech firms in Canada exhibit a high degree of R&D and a greater openness to trade.

TABLE 4
INTRAMURAL R&D EXPENDITURES OF CANADIAN-CONTROLLED FIRMS AS A PROPORTION OF THE INDUSTRY TOTAL, SELECTED INDUSTRIES, 1983-88

	1983	1984	1985	1986	1987	1988
Telecommunications equipment	90	92	80	84	89	92
Aircraft and parts	44	35	39	27	25	17
Engineering and scientific services	91	91	93	94	88	82
Business machines	23	27	28	33	27	28
Computer services	91	96	98	98	94	93
Refined petroleum and coal products	16	34	45	28	25	23
Other manufacturing industries	79	83	85	85	87	94
Total all industries	62	65	65	66	65	64

Source: Statistics Canada, 88-202.

2. What is the general performance of Canadian firms following a foreign takeover? Does productivity increase or decrease?

Foreign takeovers of Canadian firms are normally followed by productivity improvements.[8]

- Such takeovers usually generate positive productivity and efficiency gains, especially in those industries where there are significant opportunities for the complementary combining of assets between Canadian firms and foreign firms (e.g., international marketing facilities).[9]

- An analysis of the performance of manufacturing firms following a takeover indicates the following:[10]

  - Between 1983 and 1987, the number of manufacturing firms in Canada grew from 36,000 to 44,000, while the number of foreign-controlled companies remained unchanged at just under 2,000.

  - In 1987, only 4 per cent of Canadian manufacturing companies were foreign-controlled but they accounted for 45 percent of total manufacturing assets.

  - Some 28,000 companies operated in both 1983 and 1987, and just under 1,000 of them experienced a change of ownership in the intervening years. Of those, 570 companies were Canadian-controlled both before and after acquisition; 73 companies moved from Canadian control to foreign control; 57 companies moved from foreign control to Canadian control; and 207 companies were foreign-controlled both before and after acquisition.

  - The post-acquisition experience varied widely among the four sub-groups of acquired firms:

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[8] See "Distinguishing Characteristics of Foreign High-Technology Acquisitions in Canada's Manufacturing Sector," by J. Baldwin and P. Gorecki, in Investment Canada, Foreign Investment, Technology, and Economic Growth.

[9] See "Foreign Multinational Enterprises and Merger Activity in Canada," by J. Baldwin and R. Caves, in Investment Canada, Corporate Globalization Through Mergers and Acquisitions, 1991.

[10] Allen, Performance of Canadian- and Foreign-Controlled Manufacturers in Canada, 1983-87.

The financial position of firms that were *Canadian-controlled before and after acquisition* improved considerably; in particular, the return on equity and investment intensity (growth in fixed assets as a percentage of total revenues) improved very strongly.

The financial position of firms that were *Canadian-controlled before and foreign-controlled after* varied considerably, although most of them displayed improved debt/equity ratios and R&D intensity (i.e., R&D expenditures as a percentage of total revenues). Improvements in profits, sales, and returns on equity were only modest or below the industry average.

In the case of firms that were *foreign-controlled before and Canadian-controlled after*, strong gains were recorded in profits, sales, rates of return on equity, and investment intensity; however, R&D intensity did not improve, and debt/equity ratios deteriorated.

In the case of firms *foreign-controlled before and after* acquisition, the already strong performances with respect to profits, sales, rates of return on equity, and debt/equity ratios strengthened even further.

- In short, all groups of acquired companies demonstrated healthy gains in certain financial and economic aspects.

- According to data collected under the *Corporations and Labour Unions Returns Act* (CALURA), foreign-controlled firms in Canada appear to perform better than Canadian-controlled firms. In 1987, U.S.-controlled firms in the non-financial sectors generated $1.33 in revenue (sales) for each dollar of assets, compared with $1.10 for other foreign firms and $1.08 for Canadian-controlled firms. Profitability ratios are also generally better for foreign-controlled firms.

- According to an analysis of foreign multinationals operating in Canada, the following features are worthy of note:[11]

  - Foreign-controlled manufacturing plants are usually more productive than domestic-controlled plants of comparable size.

  - Domestic firms, on average, are some 15 per cent more labour-intensive than foreign firms; however, wages and salaries are essentially the same in

[11] Ronald Corvari and Robert Wisner, The Role of Foreign Multinationals in Shaping Canada's International Competitiveness, a report prepared as part of a joint study by the Economic Council of Canada and Investment Canada on competitiveness (Ottawa: 1991).

both domestic and foreign firms, and production workers as a proportion of total workers are also roughly the same. Foreign firms are not biased towards low-value-added jobs.

- Compared with domestic firms, foreign firms have a much higher propensity to both export and import; foreign MNEs account for 75 per cent of Canada's manufacturing exports.

3. What are the views of experts concerning foreign investment?

- To Professor Michael Porter, Harvard Business School, foreign versus domestic ownership is but one factor influencing the benefits from corporate activity. Foreign-owned transnational corporations (TNCs) located domestically can be substitutes or complements for home-owned TNCs, but only if the subsidiary is really independent (i.e., managed autonomously, doing its own R&D, etc.). Otherwise, the foreign-owned TNC, according to Porter, is likely to be a mere shell, reacting to directions from abroad, and creating only relatively low-value-added, low-wage jobs domestically.

  The key to assessing the consequences of foreign investment lies in the location of the home base for the industry. A home base is "the nation in which the essential competitive advantages of the enterprise are created and sustained; it is where a firm's strategy is set and the core product and process technology are created and sustained; it is where the firm contributes the most to the local economy by providing the best jobs, investing in factor creation, and helping to create clusters of reinforcing activities."[12] The home base refers to individual business units; a diversified firm may have a different home base for each of its business units.

  There is a hierarchy of benefits that a firm may provide to the countries in which it operates. Maximum benefit accrues to a country when it has ownership and the home base; minimum benefit accrues to a nation when it has neither ownership nor the home base (Chart 19). According to Porter, very few foreign-owned firms in Canada have a home base here. ICL Explosives Canada, which is a wholly owned subsidiary of Imperial Chemical Industries of the United Kingdom, is an exception. Pratt and Whitney Canada is another example of a firm with U.S. ownership but a Canadian home base (in this case, for turboprop and turbofan engines).

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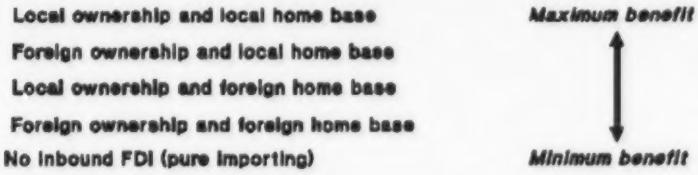
[12] The Monitor Company (Porter et al.), The Competitive Advantage of Canada, prepared under contract for the Business Council on National Issues and the Government of Canada (Ottawa: 1991).

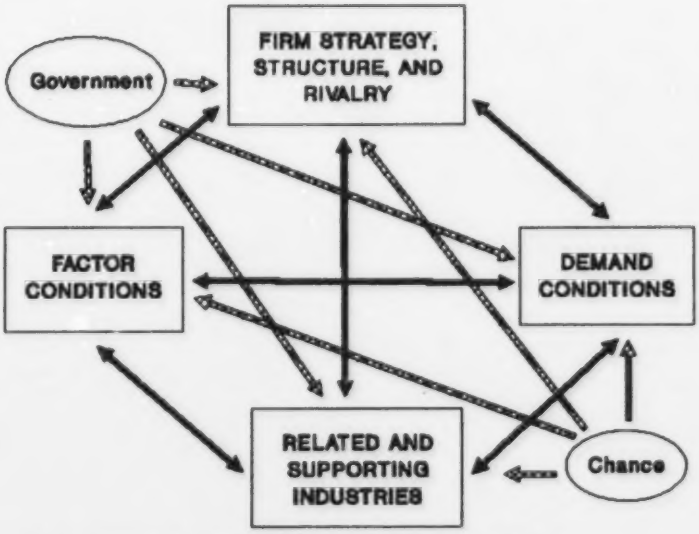
CHART 19
HIERARCHY OF BENEFITS TO HOST COUNTRY DEPEND ON A FIRM'S STRUCTURE


Local ownership and local home base
Foreign ownership and local home base
Local ownership and foreign home base
Foreign ownership and foreign home base
No inbound FDI (pure importing)
Maximum benefit
Minimum benefit

Source: Michael Porter, The Competitive Advantage of Nations (Don Mills: Collier MacMillan, 1990).

The real issue is whether Canada can provide a desirable competitive environment in order to draw the most advantageous foreign investment. The Canadian "diamond" must be sufficiently developed so that Canada will become attractive as a home base. The diamond consists of four broad determinants of competitive advantage (Chart 20).

CHART 20
THE COMPETITIVE "DIAMOND"



Source: Michael Porter, The Competitive Advantage of Nations (Don Mills: Collier MacMillan, 1990).

Notwithstanding the above views, Porter has concluded that "government policy should avoid restrictions on foreign investment and promote an export orientation with links to competitive industries and industry clusters. Government policy at present appears well aligned with the goal of avoiding restrictions on foreign investment in Canada."[13]

- *Richard Lipsey, The Canadian Institute for Advanced Research, Simon Fraser University*, has raised a number of questions about Porter's emphasis on indigenous TNCs, or the notion of home bases. For example, "since it is ridiculous to say that every small area must have its locally owned TNCs, there must be something about the national state that makes a difference; what is it?"[14]

Lipsey's views are at an investigative stage. He appears to concur with Robert Reich, who has expressed more interest in having domestically domiciled TNCs and less concern about ownership per se; however, "in a world of acquired comparative advantage, which depends heavily on human capital, much of which is acquired by on-the-job effort directed by TNCs, it is not so obvious that it is immaterial who owns the productive activities that are located within one's boundaries."[15]

If TNCs create human capital through on-the-job training, domestic workers may have higher incomes working for a TNC than if they work for domestically owned firms. TNCs typically enjoy excess profits or rents as a result of barriers to entry and oligopoly practices, and much of these excess profits or rents accrue to labour rather than to the owners of capital. Thus, it is in the interests of governments to attract foreign TNCs, because they pay high wages.

Most economists (Lipsey included) agree with Investment Canada's premise that foreign investment is good for the country and should be encouraged. Most would agree, therefore, that faced with an all-or-nothing choice on foreign investment, the decision should be to allow it.

This, however, is not the choice that Investment Canada faces when it reviews foreign takeovers; rather, it works behind the scene to amend the proposed investment so as to ensure net benefit to Canada.

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[13] The Monitor Company, The Competitive Advantage of Canada.

[14] Richard Lipsey, Economic Growth: Science & Technology and Institutional Change in a Global Economy, The Canadian Institute for Advanced Research, Publication No. 4, 1991.

[15] Lipsey, Economic Growth.

According to Lipsey, Investment Canada "inhabits a non-neoclassical world in which positive feedback loops abound, equilibrium is path-dependent, and single decisions by isolated individuals can have enormous long-term consequences. Governments throughout the world are engaged in strategic, FDI-influencing games. We ignore these at our own risk. A small push by Investment Canada might, as positive feedback theory shows, be reflected in enormous differences five to ten years down the line."[16]

- A. E. Safarian, Centre for International Studies and Department of Economics, University of Toronto, is regarded as Canada's foremost expert on foreign direct investment and the economics of multinational enterprises.[17] He foresees a possible role for government intervention, but this requires much more research.

To illustrate, Safarian has raised the following questions: "To what extent and in what sectors can domestic firms, contracts and markets substitute for the MNE? If one decides to develop local firms as substitutes, in which sectors can they be developed most efficiently?"

Clearly, reviewing foreign investment proposals to assess net benefit is difficult in the absence of answers to such questions.

Safarian has observed that while some countries still have significant restrictions against foreign investment, most countries offer incentives to investment, and to MNEs in particular. These incentives have been increasingly targeted at high-tech sectors.

All countries continue to restrict foreign ownership in some sectors; these restrictions have always been tighter for cross-border acquisitions than for greenfield investments.

Of increasing interest and concern are restrictions that are informal or non-transparent. Cross-border acquisitions may be frustrated by state holdings of shares, private concentration of shareholdings, and a variety of restrictions on takeovers; for example, large firms in Japan are protected by the fact that the majority of shares are held by banks, suppliers, and customers.

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[16] Richard Lipsey, Rapporteur's Comments, Author's Conference on Foreign Investment, Technology, and Economic Growth, September 1990. Final conference papers are scheduled for release in published form in November 1991.

[17] See, for example, A. E. Safarian, Foreign Direct Investment: A Survey of Canadian Research, The Institute for Research on Public Policy, Ottawa, 1983.

Globalization has raised awkward questions in a world where governments often appear to be doing two contradictory things: developing their own multinationals through various subsidies, protected local markets, and public ownership, while insisting they must have access to other countries' markets through the acquisition of firms and through trade. It is not difficult to see why other countries would resist such subsidized competition or be concerned about the impact of state-owned firms. To avoid trade and investment-distorting measures, Safarian has concluded that multilateral agreements are required.[18]

[18] Ed Safarian, Rapporteur's Comments, Author's Conference on Corporate Globalization Through Mergers and Acquisitions, November 1990; final conference papers are expected to be released in published form in November 1991.

The Investment Climate in Canada

1. What is meant by the investment climate and how is it judged by foreign investors?

The investment climate is a reflection of a country's competitiveness - in turn, a reflection of a country's trade and productivity performance. A great many factors determine the investment climate.

- The *World Competitiveness Report*, published annually by the World Economic Forum, assesses and ranks the competitiveness of 34 countries, using 330 criteria; those 330 criteria are grouped under eight broad factors (see Table 5).

TABLE 5
FACTORS FOR ASSESSING WORLD COMPETITIVENESS

Factor 1	Domestic Economic Strength gives an overall evaluation of the domestic economy of a country.
Factor 2	Internationalization describes the extent to which a country participates in international trade and investment flows.
Factor 3	Government describes the extent to which government policies are conducive to competitiveness.
Factor 4	Finance evaluates the performance of capital markets and the quality of financial services.
Factor 5	Infrastructure describes the extent to which resources and systems are adequate to serve the basic needs of business.
Factor 6	Management describes the extent to which enterprises are managed in an innovative, profitable and responsible manner.
Factor 7	Science and Technology evaluates scientific and technological capacity and measures the success of basic and applied research.
Factor 8	People describes the levels of availability and qualifications of human resources.

Source: World Economic Forum, World Competitiveness Report 1991

- More generally, three key sets of considerations appear to be vital:

  i) a country's overall economic performance (e.g., the rate of growth, the inflation rate, productivity growth, and relative unit labour costs);

  ii) the attitude of the government towards foreign investors (the Foreign Investment Review Agency, which preceded Investment Canada, conveyed an unwelcoming attitude); and

  iii) firm-specific requirements (for example, natural-resource-based industries must have access to the required resources; high-technology sectors must have access to skilled personnel).

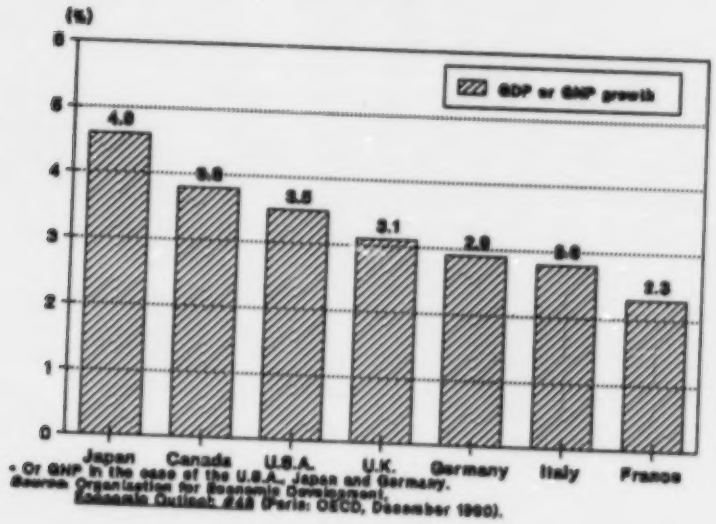
2. Is the investment climate in Canada conducive to domestic and foreign direct investment?

There are mixed views. Both positive and negative factors must be taken into consideration.

Positive factors include:

Canada's rapid economic growth over most of the post-war period. Canada has matched or outperformed the OECD average on a decade to decade basis since 1960. The 1971-80 period was particularly favourable for Canada, when the real growth rate (i.e., after abstracting from the effects of inflation) was 4.6 per cent annually. During the period between the 1981-82 recession and the 1990-91 recession, Canada's growth rate was second only to that of Japan (Chart 21). The strong growth in output was complemented by robust growth in employment, which averaged 1.8 per cent per annum over most of the 1980s. While the 1990-91 recession was more severe than had been expected, the rebound in GDP during the second quarter of 1991 (4.9 per cent at annual rates) signaled the end of the recession.

CHART 21
AVERAGE ANNUAL GROWTH IN REAL GROSS DOMESTIC PRODUCT*,
G-7 countries, 1983-90



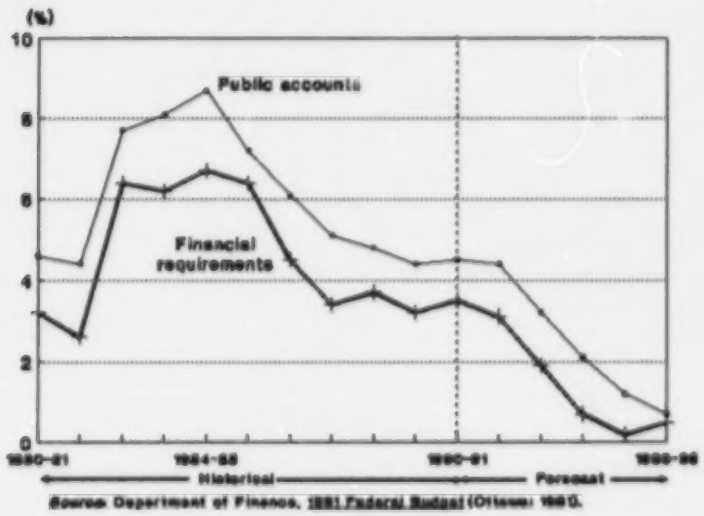
* Or GNP in the case of the U.S.A., Japan and Germany.
Source: Organisation for Economic Co-operation and Development, Economic Outlook #48 (Paris: OECD, December 1990).

Canada's strong investment performance. Since the 1960s, real gross domestic private investment has grown at a much more rapid rate in Canada compared to the United States or other G7 countries. The only exception to this statement is Japan. Private investment in Canada grew at a full percentage point more rapidly over the 1961-90 period than the average for G7 countries. Of particular interest, of course, is Canada's investment performance during the 1980s. The driving force behind the country's impressive economic growth during the latter half of the 1980s was business fixed investment; in fact, that form of investment grew at double-digit rates in 1987 and 1988. To the extent that capital expenditure on machinery and equipment leads to capital deepening, with its accompanying positive effects on productivity, Canada's investment climate can be said to have improved.

Canada's continued strength with respect to its labour force. Although there are serious shortcomings with respect to the education and training systems, Canada is known to have a highly advanced labour force. This is borne out by the fact that of the 34 countries surveyed by the World Economic Forum in 1990, Canada came second in "higher education enrolment," fourth in "secondary school enrolment," fourth in "secondary school attainment", and fourth in "public expenditure on education."

Canada's commitment to price stability and deficit reduction. Ever since its release in 1984 of the Agenda for Economic Renewal, the Government of Canada has stressed the importance of price stability in enhancing international competitiveness. The 1991 federal budget announced an inflation rate target of 2 per cent by 1995; this anti-inflation goal, in turn, complements the Government's determination to reduce the budgetary deficit (Chart 22). The primary budget balance of the federal government (i.e., excluding debt service charges) has been in surplus since 1988. The aim of substantially lowering interest rates without rekindling inflationary pressures and undermining the stability of the exchange rate has been achieved.

CHART 22
THE DEFICIT AND FINANCIAL REQUIREMENTS
AS A PROPORTION OF GROSS DOMESTIC PRODUCT,
1980-81 to 1995-96



Source: Department of Finance, 1991 Federal Budget (Ottawa: 1991).

Canada's commitment to a policy framework conducive to business. In addition to its commitments to price stability and deficit reduction, the federal government has, since 1984, implemented a number of structural reforms designed to strengthen Canada's long-term growth prospects:

- The Canada-U.S. Free Trade Agreement, the implementation of which began in January 1989.

Negotiations are under way with respect to a North American Free Trade Agreement; a NAFTA, if agreed upon, will embrace Mexico and thereby create the largest free trade area in the world.

- Canada's commitment to an "open-for-business" policy. Investment Canada, with a mandate both to regulate and promote foreign investment, replaced the Foreign Investment Review Agency in 1985. The sharp increase in the stock of both foreign direct investment and portfolio investment in Canada since the mid-1980s attests to the high level of international confidence.

- Deregulation of the energy sector.

  The National Energy Program - especially the 25-percent back-in provisions for Crown participation concerning oil and gas exploration on "Canada Lands" - was viewed as hostile to foreign investment.

- Partial deregulation of the transportation and financial sectors.

- Privatization of 25 Crown corporations and the elimination of 90,000 employees from the federal payroll.

- Reform of the unemployment insurance system, channeling more than $500 million in new funds towards enhancing job skills and retraining.

- Tax reform of the personal, corporate, and sales tax systems.

  Replacement of the federal (manufacturers') sales tax (FST) with the goods and services tax (GST) has removed the disadvantage that was incurred by exporters and import-competing firms under the old tax system.

Negative factors include:

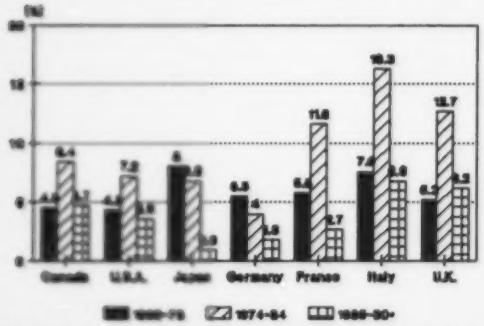
Slow productivity growth and rising unit labour costs. Of the top ten industrialized countries, Canada's productivity-growth performance is among the weakest. Unit labour costs are still rising faster than those of its major trading partners (Chart 23). Wages have not been in line with labour productivity; consequently, Canada's competitive position is being undermined.

The alleged overvaluation of the dollar. After a prolonged decline between 1976 and 1986, the Cdn dollar has continued on an upward trend, particularly against the U.S. dollar (Chart 24). This appreciation appears to be related to the

foreigners. The appreciation does not reflect a strong performance in regard to unit labour costs, productivity, and other measures of competitiveness; in that sense, the Canadian dollar is viewed by some critics to be overvalued. On the other hand, appreciation of the Canadian dollar has helped to stem inflation and to reduce the costs of production.

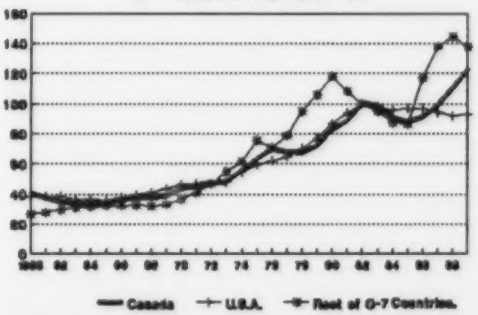
CHART 23

AVERAGE RATE OF GROWTH IN UNIT LABOUR COSTS*
G-7 Countries, Selected Periods, 1960-90



* Calculated in local currency. Data for Japan and Italy are available only to 1988 and for all other countries but Canada to 1989. Forecast data from the OECD are used to derive estimates for 1990.

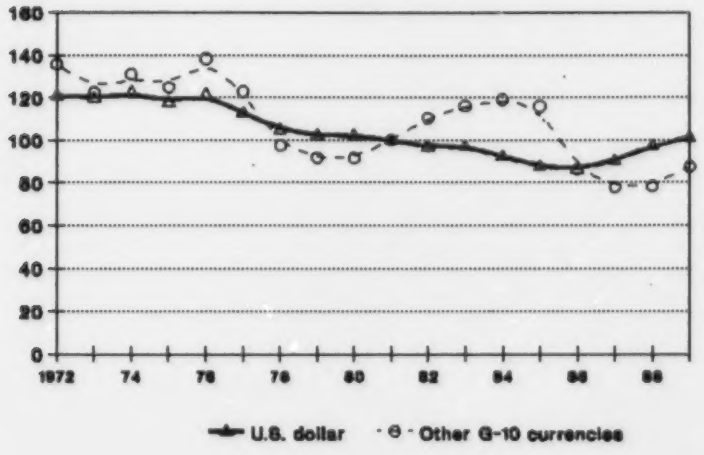
INDEXES OF UNIT LABOUR COSTS* IN MANUFACTURING, Canada, U.S.A. and other G-7 Countries, 1960-88



* Calculated on the basis of common currency in U.S. dollars.

Source: Compilations by Investment Canada based on data from U.S. Department of Labor, Bureau of Labor Statistics, 1991.

CHART 24
INDEXES OF CANADA'S EXCHANGE RATE RELATIVE TO THE U.S. DOLLAR AND OTHER G-10 CURRENCIES, (1981=100) 1972-89



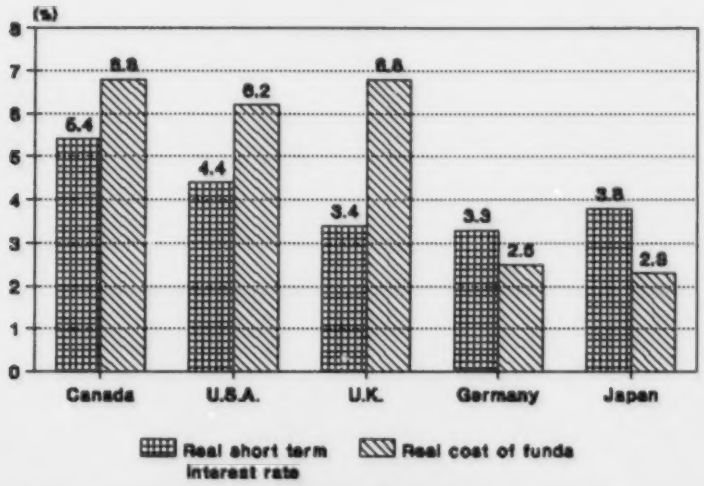
Source Department of Finance, Quarterly Economic Review, 1990.

The cost of capital. Capital for investment can be in the form of either debt or equity. The globalization of capital markets has led to a convergence of debt costs; however, significant formal and informal barriers have prevented the convergence of equity financing costs. The cost of capital in Canada, although similar to the cost in the United States and the United Kingdom, has been considerably higher at times than in Germany or Japan (Chart 25).[19] Declining inflation in Canada should help to narrow that cost-differential.

Canada's high external debt. Canada has built up a substantial liability in its net external investment position (Chart 26). This reflects, among other factors, the large deficit position of the public sector.

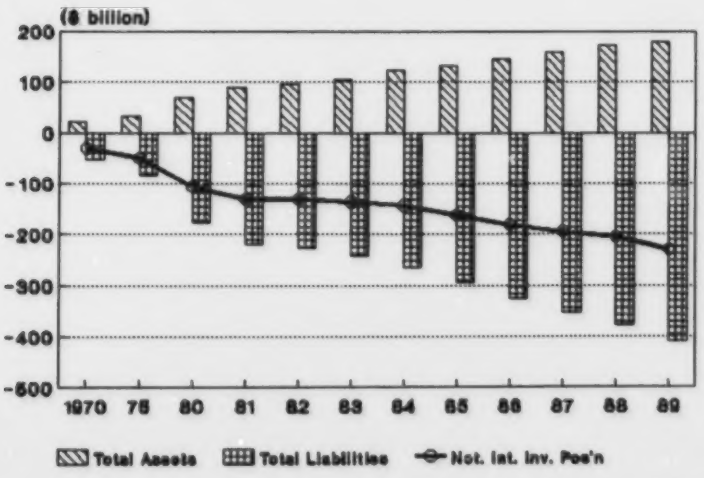
[19] The much lower cost of capital in Japan and Germany can be attributed in part to their low rates of inflation; however, the reported cost of capital in those countries may understate the "true" cost because of differences in accounting practices. For a detailed explanation of how the cost of capital is estimated, see Department of Finance, "The Real Cost of Funds for Business Investment," Quarterly Economic Review (March 1991); and Canada Consulting Cresap: "Tackling Canada's Cost-of-Capital Issue."

CHART 25
AVERAGE REAL INTEREST RATE AND COST OF FUNDS,
Selected countries, 1978-89



Source: Department of Finance, Quarterly Economic Review, March 1991.

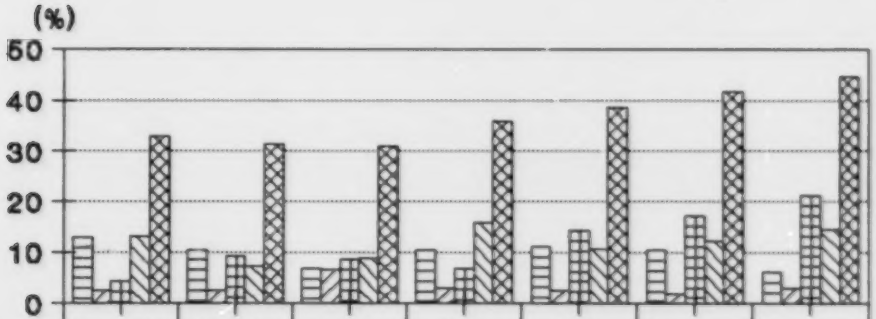
CHART 26
CANADA'S INTERNATIONAL INVESTMENT POSITION,
1970-89



Source: Department of Finance, Quarterly Economic Review, Ottawa, June 1990.

The tax burden relative to the United States. Among the G-7 countries, Canada ranked third lowest in terms of total taxes as a percentage of gross domestic product (Chart 27). Japan had the lowest tax burden, while the United States was a close second. Compared with the United States, Canada relies more heavily on personal income taxation and sales taxes. The United States, on the other hand, relies much more heavily on social security contributions. The corporate tax burden is almost the same in Canada and the United States, and less than in Japan (Chart 28). While tax to GDP ratios show Canada at some disadvantage relative to the United States, the differences are not dramatic; furthermore, the level of government services (especially with respect to health care) is generally believed to be superior in Canada.

CHART 27
INTERNATIONAL COMPARISON OF TAX BURDEN
AS A PROPORTION OF GROSS NATIONAL PRODUCT,
1989

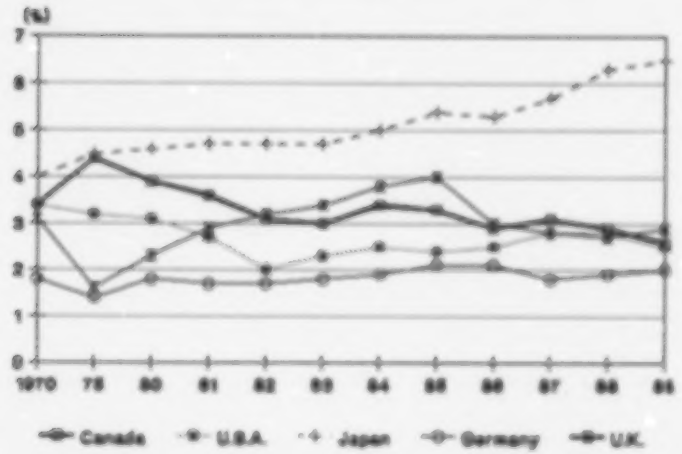


	Canada	U.S.A.	Japan	U.K.	Italy	Germany	France
Personal	12.9	10.5	6.9	10.4	11.1	10.4	6.1
Corporate	2.6	2.5	6.5	2.9	2.6	2	3
Social security	4.3	9.2	8.6	6.8	14.2	17	21.1
Indirect	13	7.3	8.9	15.8	10.7	12.3	14.4
Total tax	33	31.4	30.9	36	38.5	41.7	44.6

Personal Corporate Social security contribution
Indirect Total tax

Source: Department of Finance, Quarterly Economic Review, Ottawa, June 1990.

CHART 28
INTERNATIONAL COMPARISON OF TAXES ON CORPORATIONS
AS A PROPORTION OF GDP/GNP
Selected countries, 1970-89



(Source: Department of Finance, Quarterly Economic Review, Ottawa, June 1990)

Perceptions about the high cost of doing business in Canada. For example, a recent feature article in the Financial Post included the following cost comparisons for an appliance manufacturing company:

> "Serviced industrial land in Ohio cost about US$7,500 an acre compared to $100,000 around Guelph. Municipal taxes were lower by 60 per cent, corporate taxes by 12 per cent and interest rates by 33 per cent."

A feature article in the Southam News late in 1990 showed the contrast between the much higher burden facing taxpayers in four Canadian cities and that of Americans in similar circumstances in four U.S. cities. The anecdotal evidence, however, appears to be inconsistent with macro-economic data, which continue to show Canada as attracting considerable foreign direct investment.

The unsettling political developments in Canada. The status of Quebec is of considerable concern. While advocates of full sovereignty for Quebec make light of the costs of separation, such a development would be very serious for all regions of Canada. Uncertainty surrounding constitutional issues impacts unfavourably on risk premiums, which will be higher than would otherwise be the case if the stability of the Canadian federation were more assured. Other political developments in Canada have also received considerable international attention:

the Oka crisis during the summer of 1990 received prominent coverage in the international media, and also of concern to some business representatives has been the policy direction of the Ontario Government.

However, the overall judgment of Canada by the international community appears to be highly favourable, as reflected by foreign investor confidence and the steadily appreciating Canadian dollar. While critics cite high interest rates in Canada as the cause for increased foreign investment and an appreciating exchange rate, it should be noted that Canada's rapidly improving inflation record paves the way for real gains in the performance of the economy. Canada must continue to earn the respect of the international community through the combination of appropriate macro-economic management policies and micro-economic policies, at both the federal and provincial levels of government.

Appendix A

Background Information on Investment Canada's Review Process

The review provisions of the *Investment Canada Act* apply only to foreign acquisitions of Canadian businesses; notification provisions apply to new business proposals and takeovers below the review thresholds (generally $5 million for direct takeovers and $50 million for indirect takeovers). The Act does not apply to business expansions of existing foreign-controlled businesses in Canada or to investments that do not result in a change of control. Between June 30, 1985, and June 30, 1991, there were 5,691 foreign investment proposals received by Investment Canada; on average, approximately one in four cases are subject to full review. Most investments recorded under the Act are acquisitions (Table 6).

Following implementation of the FTA, the review threshold for direct acquisitions by U.S. investors is being raised to $150 million; indirect acquisitions by U.S. investors will, after 1991, be no longer subject to review.

Reviewable cases are subject to a "net benefit to Canada" test, based on six criteria. The number of cases subject to review has been steadily falling, from well over 200 annually prior to 1989 to an expected 120 in 1991. This reflects the phasing-in of higher U.S. thresholds and, more importantly, the sharp decline in the number of acquisitions during the 1990-91 recession.

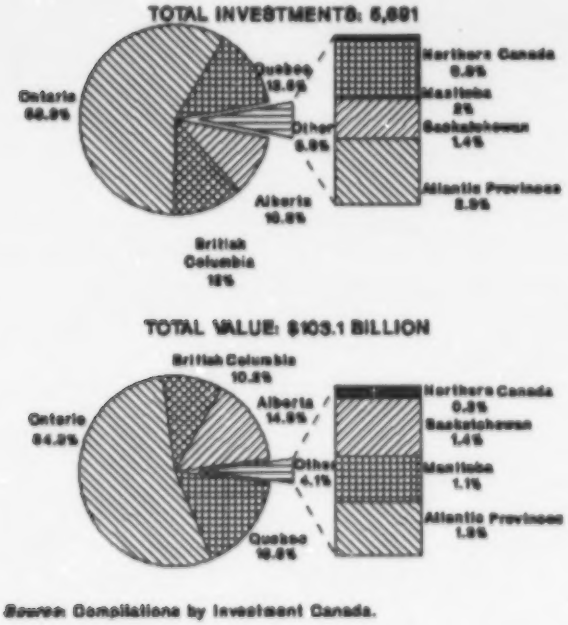
The investor's submission and business plans are sent to the provinces that would be directly affected by the investment. In accordance with the *Investment Canada Act* requirement that the industrial, economic, and cultural policy objectives of the provinces be taken into account in determining net benefit, consultations are held with those provinces in which the Canadian business being acquired has employees (Chart 29). In most cases, only one province is involved; for example, in 1990, of the 126 applications approved, 75 involved only one province. Of those, 19 involved real estate.

TABLE 6
SUMMARY OF FOREIGN INVESTMENTS

	12-month period 90/07/01 - 91/06/30		Cumulative total 85/06/30 - 91/06/30	
	No.	%	No.	%
Acquisitions	635	75.0	4,009	70.4
New businesses	212	25.0	1,682	29.6
Total	847	100.0	5,691	100.0
Reviewed and approved applications	94	14.8	947	23.6
Notifications only	541	85.2	3,062	76.4
Total	635	100.0	4,009	100.0
Direct	574	90.4	3,305	82.4
Indirect	61	9.6	704	17.6
Total	635	100.0	4,009	100.0
From: United States	481	56.8	3,350	58.9
Japan	48	5.7	274	4.8
European Community	189	22.3	1,305	22.9
Other countries	129	15.2	762	13.4
Total	847	100.0	5,691	100.0
To: Ontario	460	54.3	3,317	58.3
Quebec	118	13.9	767	13.5
British Columbia	105	12.4	685	12.0
Other provinces and territories	164	19.4	922	16.2
Total	847	100.0	5,691	100.0
In: Resources	48	5.7	369	6.5
Manufacturing	229	27.1	1,785	31.4
Wholesale and retail trade	289	34.1	1,617	28.4
In business and service industries	179	21.1	1,179	20.7
In other services	102	12.0	741	13.0
Total	847	100.0	5,691	100.0

Source: Compilations by Investment Canada.

CHART 29
INVESTMENTS, BY PROVINCIAL DESTINATION
Cummulative total, June 1985 to June 1991



Source: Compilations by Investment Canada.

Reviewable cases are also referred to those federal departments which have policy responsibilities for the industry sectors relevant to the investment proposal in question. All investment proposals are referred to the Bureau of Competition Policy for its views on the likely effects of the investment proposal on the level of competition.

The Minister must notify the investor within 45 days after a complete application has been received that he is satisfied with the business plans, that another thirty days are required for consideration of the case, or that the application is unsatisfactory, in which case the investor has thirty days to demonstrate what will ultimately be of net benefit to Canada.

All investment proposals received by Investment Canada since June 1985 have been approved; however, some foreign investment proposals have been withdrawn from consideration or were never even submitted, in the knowledge that they would not have been allowed. This possibility pertains in particular to proposals involving the culture and energy sectors. Furthermore, undertakings have been required to safeguard

Canadian interests in some 10 per cent of those foreign investment proposals subject to review.

Concern has been expressed about the loss of Canadian ownership and control of leading high-technology companies. Some 5 per cent of the cases reviewed by Investment Canada involve high-tech firms. For this purpose, guidelines have been issued to help clarify the sorts of factors used to determine net benefit in these cases (Table 7).

In the area of "cultural heritage and national identity", foreign acquisitions below the review thresholds, as well as new businesses, may be subject to review at the discretion of the Governor-in-Council. Industries that fall under the umbrella of Canada's cultural heritage include the following: the publication, distribution, and sale of books, periodicals, newspapers, and music in print or machine-readable form; and the production, distribution, sale, and exhibition of film or video products and audio or video music recordings.

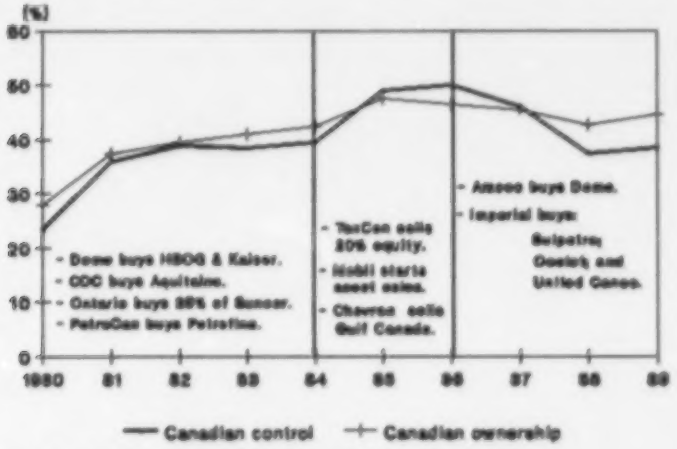
TABLE 7
FOREIGN ACQUISITIONS OF TECHNOLOGY-INTENSIVE CANADIAN COMPANIES

Investments reviewed under the Investment Canada Act to determine whether they are likely to be of net benefit to Canada are assessed on their merits by reference to the factors of assessment set out in Section 20 of the Act. In the review of the acquisition of technology-intensive Canadian companies, Investment Canada seeks evidence of the investor's intention to build the Canadian business as an internationally competitive enterprise. To this end, the Agency requires the submission of comprehensive plans, including the strategic direction, for the development of the Canadian business over the medium term. More particularly, in such cases the Agency typically seeks from the non-Canadian investor:

- assurances that the investor has, and is prepared to commit, the resources required for the Canadian business to grow as an internationally competitive enterprise, including financial, research, technological, production, marketing, and management resources;
- a commitment to the growth of the business from a Canadian base;
- assurances, despite foreign control, that the Canadian company will have meaningful autonomy and freedom to act;
- assurances of high levels of Canadian participation in the direction, management, and, where appropriate, ownership of the Canadian company;
- a commitment to significant levels of R&D spending in Canada;
- a commitment, where appropriate, to world product mandates for specified products and services (from R&D through manufacturing and marketing);
- a commitment to provide quality employment opportunities for Canadians;
- assurances that any transfer of technology between the Canadian business and the investor, or its affiliates, will be on an arms-length basis;
- assurances that any commitments that may have been given to the Crown in connection with loans or grants of public funds will be honoured by the new owners of the business; and
- a commitment to high standards of environmental protection.

Consistent with its goal of 50-per cent Canadian ownership of the country's oil and gas industry, the government maintains some restrictions on foreign ownership in the oil and gas sector (Chart 30). Under the Oil and Gas Acquisitions Policy, foreign takeovers of oil and gas companies that are already foreign-controlled are permitted, subject to a negotiated increase in Canadian ownership and/or improvement in Canadian investment spending. The policy does not permit foreign takeovers of profitable Canadian-controlled oil and gas firms with assets of at least $5 million. This threshold applies to all foreign acquisitions, including those by U.S. investors. Foreign acquisitions of Canadian-controlled oil and gas firms that are in financial difficulty are permitted, subject to a negotiated increase in Canadian ownership and/or improvement in Canadian investment spending. Under the *Canada Petroleum Resources Act* (CPRA), a corporation must have 50-per cent Canadian ownership, or a plan satisfactory to the Minister for attainment of that goal, to obtain a production licence on Canada Lands.

CHART 30
CANADIAN OWNERSHIP AND CONTROL OF THE PETROLEUM INDUSTRY
1980-89



Source: Compilations by Investment Canada based on upstream revenues.

As in other countries, Canada also has federal and provincial legislation that restricts foreign investment and ownership in particular sectors such as financial services, uranium, telecommunications, broadcasting, and transportation.

Relative to other industrialized countries, there are few informal barriers to foreign investment in Canada. The intent of Canada's foreign investment legislation is to review only takeovers of significant Canadian businesses and to ensure that, when approved, they are of net benefit to Canada.

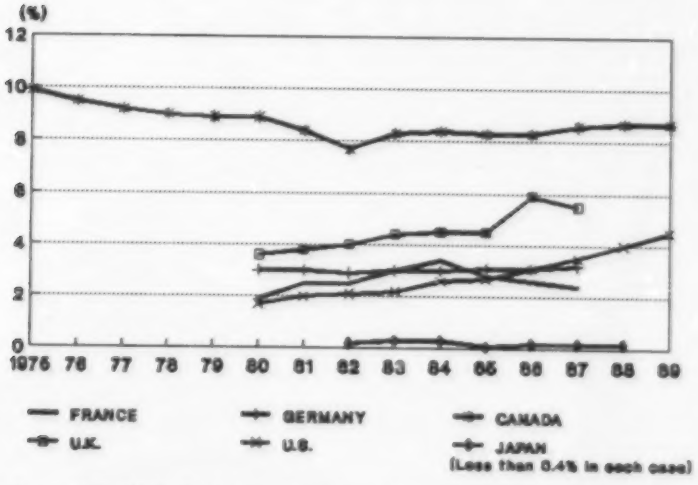
Appendix B

Foreign Investment Policies in G-7 Countries

The surge of foreign direct investment among G7 countries during the 1980s resulted in some countries registering a significant increase in the stock of private non-residential capital investment owned by foreigners. As may be seen from Chart 31, this was particularly the case for the United States. Its role as a "home" or "source" country has greatly diminished - relative to Japan, Germany and the United Kingdom - while as a "host" country it now accounts for more than 25 percent of total world direct investment.

The rapid growth of foreign direct investment in the United States has given rise to proposals for limiting such investment. However, with the exception of the Exon Florio provisions introduced in 1988, which provide for the review and possible blocking of foreign takeovers when "national interest" is at stake, the U.S. Administration has resisted such pressures. In fact, most G7 countries (including Canada) have liberalized their foreign investment regimes - at least those formal aspects such as screening and performance requirements.

CHART 31
STOCK OF FDI AS A PERCENTAGE OF GROSS PRIVATE NON-RESIDENTIAL CAPITAL STOCK
Selected Countries



Source: IMF, OECD Capital Stock est. from National Sources.

There remain, nonetheless, a wide variety of informal barriers to foreign direct investment. To illustrate the distinction between formal and informal barriers, the situation in France, Germany and Japan is very briefly described below:[20]

France, which has traditionally had more controls on foreign investment than most G-7 countries, has recently abolished exchange controls and has relaxed administrative requirements to expedite the investment screening process; domestic firms, however, have been allowed a variety of defensive tactics to resist hostile foreign acquisitions.

Germany formally has the most liberal policies towards foreign investment of all G-7 countries, but there are some serious impediments at an informal level. For instance, the disproportionately high ownership of German corporations by domestic banks, combined with highly interlocking management structures, can bar foreign investors from acquiring firms, except when deemed "friendly." Germany also has very strict anti-trust laws.

Japan has made some significant progress in removing many restrictions on foreign investment in the last decade. Nevertheless, it continues to have the serious informal impediments to foreign investment. These barriers range from business cultural constraints, such as the keritsu system, to more direct impediments, such as the government's use of "administrative guidance" to dissuade potential investors from their plans if they conflict with local business interests. Foreign direct investment in Japan is very low: less than 1 per cent of corporate assets are foreign-controlled.

- Current OECD and GATT initiatives focus only on formal barriers to investment, leaving the informal barriers unresolved. This favours countries like Japan, at the expense of countries like the United States and Canada where most barriers to investment are transparent. Also, the point of diminishing returns may have been met with respect to the removal of traditional barriers to investment flows. A multilateral investment accord embracing both formal and informal barriers to foreign direct investment would appear desirable.[21]

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[20] For an elaboration see Ash Ahmad and John Knubley, Barriers to Foreign Direct Investment in the G-7 Countries, Investment Canada, Working Paper (forthcoming).

[21] Strategico Inc., A Multilateral Investment Accord: Issues, Models, and Options, Investment Canada, Working Paper No. 8 (Ottawa: June 1991).

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